83-183

No. 83-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

LTV FEDERAL CREDIT UNION,

Petitioner

v.

UMIC GOVERNMENT SECURITIES, INC., and
BANCO DE LA NACION ARGENTINA,

Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

1. Prior to the 1982 Congressional amendments to the definition of a "security", were options, puts, calls and straddles on securities, including exempt securities, subject to the Federal Securities Laws?

2. Should the Court of Appeals have applied the then existing definitions of securities, as amended by Congress in 1982, when deciding this case in 1983 rather than its interpretation of the pre-amendment law?

3. Is an unregistered, unlicensed securities broker/dealer who provides facilities and makes a market in securities by bringing buyers and sellers together an "Exchange" as defined by the Securities Exchange Act of 1934? (a matter of first impression)

4. Is a Federal Credit Union authorized by the Federal Credit Union Act to enter into options on securities where the Act does not specifically so provide? (a matter of first impression)

5. Should the Court of Appeals have applied the federal regulation prohibiting federal credit unions from entering into standby option contracts as promulgated in 1979 in this case when decided in 1983?

LIST OF PARTIES

1. LTV Federal Credit Union, Dallas County, Texas, Petitioner

2. UMIC Government Securities, Inc. (and UMIC, Inc., its parent corporation), Memphis, Tennessee, Respondent

3. Banco de la Nacion Argentina, New York, New York, San Francisco, California, Respondent

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Petitioner LTV Federal Credit Union respectfully requests that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered on May 6, 1983 in Case No. 81-1533.

OPINIONS BELOW

The opinion of the Court of Appeals in No. 81-1533, which is reproduced in the Appendix beginning at page A-1, is reported at 704 F.2d 199 (5th Cir. 1983). The opinion of the United States District Court for the Northern District of Texas, which opinion was adopted by the Court of Appeals, is reproduced in the Appendix beginning at page B-1, and is reported at 523 F.Supp. 819 (1981).

JURISDICTION

The judgment of the Court of Appeals was entered on May 6, 1983. This petition was filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1). Jurisdiction in the District Court was conferred by 15 U.S.C. Section 77v, 15 U.S.C. Section 78aa, and diversity with an amount in controversy exceeding $10,000 exclusive of interest and costs.

STATUTES AND REGULATIONS INVOLVED

This case involves questions arising under the Securities Act of 1933, the Securities Exchange Act of 1934, the Federal Credit Union Act, the corresponding Federal Code of Regulations issued pursuant thereto, the corresponding Texas Blue Sky Law, and the Gaming and Bucket Shop Statutes of the State of Tennessee. These are codified as follows:

> 12 U.S.C. Sec. 24; 12 U.S.C. Sec. 1757; 12 U.S.C. Sec. 1757 (7); 15 U.S.C. Sec. 77b; 15 U.S.C. Sec. 77e; 15 U.S.C. Sec. 77 1; 15 U.S.C. Sec. 77p; 15 U.S.C. Sec. 77q; 15 U.S.C. Sec. 77v; 15 U.S.C. Sec. 78c (1) (1); 15 U.S.C. Sec. 78e; 15 U.S.C. Sec. 78g; 15 U.S.C. Sec. 78i; 15 U.S.C. Sec. 78j; 15 U.S.C. Sec. 78o; 15 U.S.C. Sec. 78aa; 15 U.S.C. Sec. 78cc; 12 CFR Sec. 703.3 (a) (2); 12 CFR Sec. 703.3 (b) (2); 12 CFR Sec. 703.3 (b) (3); 17 CFR Sec. 240.10 (b) -5; Vernon's Annotated Texas Statutes, Articles 581-1 et. seq. 581-39; and Tennessee Code Annotated Section 39-2020; Section 39-2021; and Section 39-2023.

The pertinent portions of all statutes and codes referred to in the petition are set forth in the Appendix and indexed in the table of contents thereto.

STATEMENT OF THE CASE

Proceedings and Disposition in the Courts Below. This suit was filed in the United States District Court for the Northern District of Texas, Dallas Division, by Plaintiff LTV Federal Credit Union (LTV). LTV filed suit seeking a declaratory judgment that a certain agreement denominated a "Standby Commitment" was unenforceable because, *inter alia,* the agreement was a "security" sold in violation of federal and state securities laws, that LTV lacked statutory authority to enter such an agreement, and that the defendant operated as an unregistered securities exchange.

The defendant was UMIC Government Securities, Inc., a Tennessee corporation, with its principal office located in Memphis, Tennessee (UMIC). UMIC later filed a Complaint alleging anticipatory breach of a contract, which was transferred and consolidated with the action filed by LTV.

Thereafter Banco de la Nacion Argentina, an agency of the Republic of Argentina (Banco), with branches in New York and San Francisco, filed a Motion to Intervene as Plaintiff against UMIC, on virtually the same grounds as LTV, including fraud. UMIC and Banco then settled by assignment of a part of UMIC's counterclaim and Banco withdrew its complaint and was joined with UMIC. The case was tried without a jury and judgment against LTV and in favor of UMIC and Banco was entered. 523 F.Supp. 199 (1981). LTV appealed. The Court of Appeals affirmed, expressly adopting the District Court's opinion. 704 F.2d 199 (1983).

Both courts held that the option on GNMA securities was not a security. The circuit court also refused to apply the 1982 amendments to the Securities Acts of 1933 and 1934 in which Congress specifically included in the definitions of securities "options" on securities. These amendments were passed while

the case was pending argument in the Court of Appeals. Likewise both courts refused to apply the current federal regulation declaring it to be illegal for federal credit unions to enter into standby option contracts exactly like the one in issue in this case. The Court of Appeals overruled all Petitioner's grounds, including its argument that UMIC was an unregistered exchange.

Nature of the Case. The case involves two written agreements or options to sell securities known as GNMA's (Ginnie Maes).[1] These options were drawn up by UMIC on their standard printed forms and designated as "Standby Commitments" (Standbys). UMIC sold one Standby to Banco (the Banco Standby). For a fee ($240,000) UMIC agreed to purchase, at Banco's option, $4,000,000 principal amount (plus or minus 2.5%) of 8½% GNMA securities at a price of 101% of principal, to be delivered and paid for July 22, 1980.[2] UMIC then subsequently entered an almost identical Standby (the LTV Standby) which it solicited and purchased from LTV (for $200,000) whereby UMIC could sell a like number of GNMA's to LTV to "cover" UMIC's exposure should Banco exercise its option to sell to UMIC. UMIC could and did require LTV to put up a "margin," but Banco had no right to require a margin of UMIC. These are referred to as "paired transactions" and are commonly known as put options in the securities industry.[3]

Facts in the Record Necessary to Understand the Issues. LTV is a federally chartered corporate-sponsored credit union, with capital composed principally of member's deposits. Its board

[1] Government National Mortgage Association mortgaged-backed pass-through certificates.

[2] By custom, however, UMIC and Banco could settle out without delivery as they had in the past.

[3] A call option gives the holder the right to purchase a specific quantity of the underlying security from the writer of the options contract at a specified price during the life of the option. A put option similarly gives the holder the right to sell a specific quantity of the underlying security to the writer of the options contract. See generally Report of the Special Study of the Options Markets to the SEC 73-75 (Comm. Print 96-IFC3 1978).

consisted of past and present employees of its corporate sponsor who, at the times involved, had no formal training or previous experience in banking, securities, investments or mortgage banking. The credit union manager (the only paid officer or director) who entered into the Standby Agreement in question with UMIC had no formal education after high school, and no training or experience with investments or the investment activities of LTV prior to becoming the manager.

UMIC was organized in March 1978, with offices in several states. UMIC was not registered as a broker or dealer under any state or federal securities law, was not a member of any exchange or board of trade, and was never registered as a securities exchange. UMIC employed approximately 100 salesmen who operated in an area referred to as the "brokerage floor" in which numerous salesmen, using telephones, sought to move securities listed for sale or purchase on blackboards by finding purchasers and sellers in telephone calls. UMIC employees testified that UMIC "made a market" by "bringing buyers and sellers together," mostly in government securities. None of these transactions were ever effected through a recognized exchange.

Banco had traded with UMIC, primarily in short term futures contracts on GNMA's which were settled without delivery, "on the margin" for a number of years at the time of the transactions herein. Banco had lost money and was indebted to UMIC.

After entering the Banco Standby, UMIC's salesman (formerly a used car salesman) solicited LTV to enter the LTV Standby. UMIC did not explain any of the inherent risks or present a copy of the proposed Standby to LTV. There was no discussion about the "yield maintenance clause"[4] or its operation

[4] The LTV Standby Option Agreement contained the following language:

In the event that the F.H.A. Mortgage Rate is changed during the term of this commitment, we may deliver GNMA securities bearing a corresponding change from the securities interest shown above. In this event we will deliver the new rate securities at a price which will produce the same yield as provided by this contract. (Yields to be calculated on the basis of Prepayment in 12 years).

or "margin" requirements. UMIC did not disclose that the LTV Standby was paired with Banco. Both Standby Agreements were thereafter prepared by UMIC, dated June 26, 1978, and both were signed as of that date. Both had the same settlement date, July 22, 1980. The effect of this was that if mortgage interest rates went up by July, 1980, Banco would elect to give notice of delivery because they would make a profit. UMIC would likewise give notice to LTV because it was not financially able to sustain a loss. UMIC never had sufficient assets or reserves to fund this transaction and this was not disclosed to LTV. Thus LTV would stand the entire loss. Conversely, if interest rates went down, neither Banco nor UMIC would exercise the put to LTV. LTV could not reasonably expect to profit more than the initial $200,000 it had received but could, and in fact has, suffered a far greater loss.

UMIC's salesman believed interest rates were going to go up, but he did not disclose this to LTV, nor did he tell LTV about Banco. UMIC had none of its funds in the transaction as it had received $240,000 for the Banco Standby.

Just weeks after both Standbys had been executed, the Agency Administrator of the National Credit Union Administration (NCUA) publicly stated that standby contracts were in essence put options, futures, and thus separate securities from the underlying lawful securities and were *unlawful* for credit unions. On October 17, 1978, a notice of proposed rules to this effect was published in the Federal Register, Vol. 43, No. 201, (App. F-1). Until LTV contacted attorneys following a margin call, LTV was unaware of the risks involved in the "yield maintenance clause" in the LTV Standby, especially that UMIC using that clause might choose to deliver something other than 8½% GNMA's increasing the cost under the LTV Standby to $5,000,000 or more instead of the $4,000,000 set forth in the LTV Standby. By March 24, 1980, UMIC had been informed by LTV's attorneys

that their margin call was "unenforceable." and further that LTV could not honor the Standby because it was an illegal contract for a federal credit union. UMIC then, for the first time, advised LTV that they intended to deliver *not* 8½% GNMA's, but rather 12½% GNMA's at a cost to LTV of $5,873,600. UMIC also revealed the paired Standby for the first time and alleged, falsely, that UMIC was under an unconditional obligation to purchase and pay in cash for the same GNMA securities which LTV was committed to purchase from UMIC.[5] On June 17, 1980, UMIC demanded performance from LTV. LTV offered rescission which was "flatly refused" by UMIC. UMIC also refused to identify the other party, Banco, so the matter could be resolved before anyone had suffered a great loss.[6] On June 24, 1980, LTV filed its Complaint seeking a declaratory judgment that the Standby with UMIC was unenforceable. The next day, June 25, 1980, UMIC filed suit against LTV for breach of contract.

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[5] This statement was not in fact true since Banco did not give written notice to UMIC of its intent to deliver until June 12, 1980. UMIC, on June 11, 1980, sold to Banco for $4,240,000, $4,000,000 par value, of GNMA 10%'s, a price above market, to be delivered in July. This was supposedly done "in order that Banco would have GNMA's available to it to deliver to UMIC on July 22, 1980," the settlement date under both Standby Commitments. UMIC had not told Banco that LTV would not accept the delivery from UMIC, and at this time UMIC was not financially able to purchase $4,000,000 in GNMA's. UMIC's balance sheet for June 1980 shows total net assets of $345,000. The July 1980 shows total net assets had dropped to $170,000.

[6] Banco did not discover any of this until July 15, 1980. Banco not knowing of the dispute took delivery and paid UMIC in excess of $4,240,000 for GNMA securities. They were not however 8½% GNMA's; they were instead 10% GNMA's. On July 3, 1980, UMIC sent a Mailgram to Banco noting that Banco had *not* properly elected to deliver the GNMA's under the Banco Standby to UMIC and thereafter refused to honor the Banco Standby with Banco while insisting that LTV honor the LTV Standby. Thus, instead of simply passing Banco's GNMA on to LTV, which would have left UMIC with only its original $40,000 commission, UMIC could now reap the entire profit of well over $1,500,000, which so far they have.

REASONS FOR GRANTING THE PETITION

THE OPINION OF THE COURT OF APPEALS THAT OPTIONS ARE NOT SECURITIES IS INCONSISTENT WITH ACTION BY THE CONGRESS, INCONSISTENT WITH HOLDINGS OF THIS COURT AND OTHER COURTS WITH THE RESULT THAT THE COURT OF APPEALS HAS HELD THAT ALL OPTION TRANSACTIONS ON SECURITIES PRIOR TO THE CONGRESSIONAL AMENDMENTS ARE EXEMPT FROM THE SECURITIES LAWS

The Court of Appeals and the District Court held in this case that the LTV Standby, an option contract on GNMA securities, was not a security under the federal securities laws. In doing so, the Court of Appeals is in direct conflict with decisions of this Court, the Sixth Circuit, the Ninth Circuit, the Tenth Circuit, and numerous district courts, the Supreme Court of Texas and the expressed intent of Congress.[7]

Prior to argument before the Court of Appeals in this case, this very issue was decided by the Court of Appeals for the Seventh Circuit in *Board of Trade of City of Chicago v. S.E.C.*, 677 F.2d 1137 at 1155-1159 (1982) holding that option contracts on GNMA's are not securities. The Seventh Circuit had cited the District Court's opinion under review herein as authority. *Id.* at 1158.[8] That decision provoked a furor in both the securities industry and Congress. Petitions for Writs of Certiorari in *Board*

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[7] Cases cited and discussions herein at pages 11 to 14 *infra*.

[8] As the Seventh Circuit relied heavily in *Board of Trade* upon the opinion of the District Court in this case to support its holding that an option on a GNMA is not a security and the Fifth Circuit now relies on *Board of Trade* in its opinion, the actual effect of this anomaly is to have the District Court's opinion in this case serve as authority to sustain the District Court's opinion in this case.

of Trade and a companion case were promptly filed in this Court.[9] During the pendency of these Petitions, Congress acted specifically to overturn the decision in *Board of Trade* by amending the 1933 and 1934 Securities Acts expressly to include, *inter alia*, options on securities within the definition of a "security" in both the 1933 and 1934 Securities Acts by inserting the following additional language: ". . . any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof) . . . ." Pub.L. No. 97-303, 96 Stat. 1409 (now codified at 15 U.S.C. Sections 77b(1), 78c(a)(10), 78(i), 78bb(a), 78 lll(14), 80a-2(a)(18) and 80a-2(36)) (App. F-15 and F-16). As set forth in the legislative history (App. C-1), this action by Congress was a dramatic statement of its belief that options on securities had always been securities within the meaning of the federal securities laws. Even the Court of Appeals in its opinion recognized Congressional attitude:

> "On the other hand, the legislative history of the bill, embodied in a rather lengthy House Energy and Commerce Committee report, is laced with such phrases as 'clarification of SEC jurisdiction,' 'long-standing Congressional intent that the SEC has the sole authority to regulate options on all securities, including exempted securities,' and 'confirm the intent of Congress.' H.R. Rep. No. 97-626, 97th Cong., 2d Sess. 2, 8, 9, U.S. Code Cong. & Admn. News 1982, pp. 2780, 2786-87." 704 F.2d at 202. (App. A-7-8)

Yet the Court of Appeals gave no weight whatsoever to this expressed intent of Congress in its consideration of this case, stating: "This *clarification* terminology is not in itself dispositive of the issue before us," and "*congressional commentary*

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[9] See Petitions for Writs of Certiorari filed with this Court in the *Board of Trade* cases: No. 82-237 *Chicago Board of Options Exchange, Incorporated and The Options Clearing Corporation v. Board of Trade of the City of Chicago* and No. 82-526 *Securities and Exchange Commission v. Board of Trade of the City of Chicago and Chicago Board of Options Exchange, Inc.*

notwithstanding, it was *not clear* that an option on an exempt security (GNMA's) was itself a security for purposes of registration prior to the 1982 amendments." 704 F.2d at 202 (App. A-8) (emphasis added).

The Court of Appeals below relied heavily upon the *Board of Trade* case to reach its position that the issue was "not clear." 704 F.2d at 202.(App. A-9). In relying on the *Board of Trade* case after Congress had expressly attempted to legislate it out of existence, the Court of Appeals ignores the Congressional expressions of intent unavailable to the Seventh Circuit and the District Court herein at the time they construed these definitions and statutes.[10] The Court of Appeals had such guidance from Congress, but failed to even reanalyze the District Court's interpretation.

Given this confirmation of this intent of Congress together with the previously decided cases from other courts, it is obvious that an option on a GNMA security was itself a security even prior to the 1982 Congressional Amendments. This point was extensively briefed and presented to this Court in the petitions for writs of certiorari filed in *Board of Trade* . The SEC, the Securities Industry Association, the Chicago Board of Options

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[10]The Congress was quite explicit in its intent to specifically overturn the holding of the Seventh Circuit. In its report recommending enactment of this legislation, the Committee on Energy and Commerce stated: "Although the word 'option' is not explicitly included in the definition of 'security,' a call option on a security is a 'right to purchase' a security and both put and call options [on] securities are considered instruments 'commonly known as' securities." House Rep. No. 626, 97th Cong., 2d Sess. Part I at 3 (1982) (App. C-3). The House Committee also stated its belief that the decision by the Seventh Circuit Court of Appeals 'is not consistent with long-standing Congressional intent that the SEC has the sole authority to regulate options on all securities, including exempted securities." Id. at 6 (App. C-6). The Report of the Senate Committee on Banking, Housing, and Urban Affairs similarly stated that the "comprehensive authority [of the SEC] to regulate securities extends to put and call options on securities" and that options "currently are considered to be within the definitions of 'security'" in the federal securities laws. S. Rep. No. 390, 97th Cong., 2d Sess. 3,5 (1982).

Exchange, Inc., and the Options Clearing Corporation all strongly opposed the Seventh Circuit's holding that an option on a GNMA was "not a security."[11] After the Congressional Amendments, on a suggestion of mootness filed in this Court, a dispute arose between the Petitioners and the Respondent in *Board of Trade* as to whether the Seventh Circuit's opinion should be vacated, because although the jurisdictional dispute between the SEC and the Board of Trade had been resolved, the confusion created in the securities industry and the case law was far reaching and that failure to vacate the Seventh Circuit's judgment and thus nullify its opinion would leave more questions unresolved than had been settled.[12] Apparently this Court concurred for it granted the Petitions and then vacated the judgment of the Seventh Circuit, remanding the case to be dismissed as moot. _____ U.S. _____, 103 S.Ct. 434 (1982).

The District Court's opinion analyzes the entire issue of whether the LTV Standby was itself a "security" based on its erroneous analogy of the Standby to a commodity futures contract, the very same erroneous approach used by the Seventh Circuit in *Board of Trade*. The District Court completely ignores that the Standby was, in essence, a one-way "option" with no ready market in which LTV could sell the "contract" prior to "delivery" to cut its losses. The risks in commodities futures contracts on "real" commodities are entirely different from the risks involved in the LTV Standby. By focusing on the "commodity" issue in its securities law analysis, the District Court, and thus the Court of Appeals, *never* properly analyzed the LTV Standby as a "security."

By jumping directly to the issue of retroactive application, the Court of Appeals has not addressed, except by adoption of the District Court's opinion, the most important issue in the case: whether such options on securities, including otherwise exempt

[11] *Supra*, Note 9.

[12] See Reply Briefs of Petitioners in *Board of Trade*, No. 82-327 and No. 82-526, *supra*, Note 9.

securities, were in fact within the definition of a "security" *prior to* the Congressional Amendments. A review of cases on this point illuminates a conflict between the Seventh Circuit's vacated opinion in *Board of Trade* and the Fifth Circuit's opinion herein and numerous other decided cases: the Sixth Circuit Court of Appeals, which held that the definition of security in the Securities Exchange Act "clearly includes options to purchase or sell stock." *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (1979); the Ninth Circuit which held that naked double options to buy and sell commodity futures contracts were securities as defined by the Securities Act of 1933. *S.E.C. v. Commodity Options International, Inc.*, 553 F.2d 628 (1977); the Tenth Circuit which held that a "standby" or "take out" commitment to pick up a mortgage loan was a security as defined by the Securities Act of 1933. *United States v. Austin*, 462 F.2d 724, 736 (1972); and the Supreme Court of Texas which held under Texas Securities Laws that options on commodities were securities, citing many federal cases. *Searsy v. Commercial Trading Corp.*, 560 S.W. 2d 637, S.Ct. 1978. The great majority of federal district courts have likewise agreed that options on securities are separate securities.[13]

[13] See, e.g., (1) *In re McDonnell Douglas Corp. Securities Litigation* [Current Binder] Fed. Sec. L. Rep. (CCH) ¶98,737, at 93,723 (E.D. Mo. June 22, 1982); (2) *Backman v. Polaroid Corp.*, 540 F. Supp. 667, 671 (D. Mass. 1982) ("Call options are securities within the meaning of Section 10(b) * * *." (3) *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1186 (S.D.N.Y. 1981); Savino v. E. F. Hutton & Co., 507 F. Supp. 1225, 1235 (S.D.N.Y. 1981) ("the * * * stock options that defendants purchased and sold * * * undoubtedly constituted 'securities.' "); (4) *Lloyd v. Industrial Bio-Test Laboratories, Inc.*, 454 F. Supp. 807, 822 (S.D.N.Y. 1978) ("Calls have been explicitly and implicitly recognized as securities"); (5) *Lubin v. Belco Petroleum Corp.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,543, at 94,237 (S.D.N.Y. Aug. 24, 1978) ("An option to buy or sell a security involves investment risks paralleling those entailed in ownership of the underlying security and is thus a security itself." (6) *Piemonte v. Chicago Board Options Exchange, Inc.*, 405 F. Supp. 711 (S.D.N.Y. 1975) (recognizing that standardized options traded on the CBOE are separate securities subject to separate registration and investor disclosure requirements under the securities laws; (7) *Vogel-Lorber, Inc. v. Options on Shares, Inc.*, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,911, at 97,109 (S.D.N.Y. Dec. 9, 1974)

It would likewise appear that the Fifth Circuit in ignoring the actions of Congress and this Court taken in response thereto has created a direct conflict with the action of this Court in vacating *Board of Trade*.[14] In its opinion, the Court of Appeals does not even mention that this Court had vacated that opinion on November 29, 1982.

The practical effect of leaving the judgment and opinion of the Court of Appeals (and the District Court's opinion which was adopted) on the books is to substitute it for that of the Seventh Circuit in *Board of Trade*. This would create great uncertainty in numerous regulatory enforcement areas where "options" on securities have been either by statute, regulation or industry practice treated as securities. As pointed out by the Securities Industry Association in its motion and *amicus curiae* brief filed in *Board of Trade*, at pp.7-11, many members are brokers and dealers in both securities and commodities, and there are different rules for margin, registration and suitability. The House Committee on Energy and Commerce in its report in support of the confirming legislation, points out additional areas where confusion has been created by the decision that an option on a security is not a security itself. (App. C-1). The Fifth Circuit's holding in this case, if allowed to stand, means that only in those cases arising after October 13, 1982 (the effective date of the 1982 amendments) are such options on securities to be treated as within the protective umbrella of all of the federal securities laws and related regulations. Even worse, the opinion could remove the prior protection of these laws as applied to options.

("it is apparent that the SEC intended that options be considered as securities * * *."); (8) *Globus, Inc. v. Jaroff*, 271 F. Supp. 378, 380 (S.D.N.Y. 1967) ("It is axiomatic that * * * an option agreement is a security under the 1934 Act * * *"); (9) *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262, 292 (S.D.N.Y. 1966) rev'd in part on other grounds, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) ("A stock option is a security * * *.").

[14] See also, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917 (1975), which has been repeatedly cited for the proposition that options are themselves securities.

The Court of Appeal's opinion creates an entirely new exempted security, one not enumerated in the statute:

> "And even if the standby commitment is considered a 'security' then as a 'stock option' in GNMA's, it is no more subject to registration than the underlying GNMA's. 704 F.2d at 201. (App. A-4, 5).
>
> "It cannot be said that options on exempt government securities were so considered separate securities for purposes of registration prior to the 1982 amendments." 704 F.2d at 203. (App. A-11).

The LTV Standby was issued by UMIC and prepared on printed forms of UMIC. It was *not issued by nor was it guaranteed by any agency or quasi-agency of the United States Government*. It involved risks separate and apart from the GNMA securities which formed the subject of the option but which in fact furnished only the market quotations necessary to determine who lost or won and by how much.

Thus, this case now stands as the last definitive statement by a federal appellate court on this issue. The decision calls into question the SEC's regulation of all options. Since 1973, the Options Clearing Corporation has registered options on securities in accordance with the registration provisions of the Securities Act. The impact of such a result is staggering. For example, in 1980 over 80 million options with a value in excess of $41 billion were traded on the CBOE and other exchanges. The Court of Appeals' opinion calls into question the appropriate regulatory scheme for all such trading and can only cause economic mischief to the major securities exchanges of this country and to the industry. See Brief *Amicus Curiae* of the Securities Industry Association, in No. 82-327, p.9, *supra* note 9.

THE COURT OF APPEALS DECISION ON RETROACTIVE APPLICATION OF STATUTORY CHANGES IS DIRECTLY CONTRARY TO AND MISINTERPRETS DECISIONS OF THIS COURT

The Court of Appeals opinion, Part II, is directly in conflict with the consistent line of decisions from this Court for the last 182 years on the issue of retroactive application of statutory changes which occur during the pendency of direct review. Beginning with *United States v. Schooner Peggy*, 1 Cranch 103, 2 L.Ed. 49 (1801) extending consistently through *Thorpe v. Housing Authority of City of Durham*, 393 U.S. 268, 89 S.Ct. 518, 21 L.Ed. 474 (1969) and *Bradley v. School Board of City of Richmond*, 416 U.S. 696, 40 L.Ed. 476, 94 S.Ct. 2006 (1974), the general rule has consistently been that an appellate court on direct review is to apply the law in effect at the time of its decision, not the law in effect at the time of the trial court's decision or the transaction. In *Bradley*, this Court stated: "*Thorpe* stands for the proposition that even where the intervening law does not explicitly recite that it is to be applied to pending cases, it is to be given recognition and effect." 416 U.S. at 715, 94 S.Ct. at 2018.

The Court of Appeals has misconstrued 182 years of this Court's decisions to completely "shift the burden" on retroactive application from the general presumption of *Thorpe* and *Bradley* to a restrictive application only in cases "vindicating rights of great national concern." This approach dramatically changes the analytical approach to retroactive application by limiting the presumption to matters of "great national concern" and unduly enhancing the "manifest injustice" exception by virtually presuming that such injustice will result if retroactive application destroys a cause of action between private litigants.[15] In virtually

[15] The Court of Appeals has misread the clear import of this Court's language in *Gulf Offshore Co. v. Mobil Oil Corp.*, 453 U.S. 473, 101 S.Ct. 2870, 69 L.Ed. 784 (1981) at note 16, by reading the dicta in that note as a

every instance where retroactive application of a change in a statute or regulation is considered by a court, application of the change will create or take away something affecting an existing "right," quite often the cause of action itself. This Court should clearly reestablish the general rule and clarify the parameters of the "manifest injustice" exception in *Thorpe* and *Bradley*. To leave the Court of Appeals opinion in place would rewrite 180 years of jurisprudence.

First, Petitioner submits that the legislative history cited herein[16] clearly shows that Congress intended its action to apply to all pending litigation. Just as this Court noted in *Bradley*, the legislative history "would seem to provide at least implicit support for the application of the statue to pending cases." 416 U.S. at 716; 94 S.Ct. at 2281.

Having shifted the emphasis away from the general rule, the Court of Appeals then interprets the facts under the "exception" to reach its result. *Bradley* recognizes the "manifest injustice" exception but suggests that a court should consider the following factors in analyzing its applicability: (a) the nature and identity of the parties; (b) the nature of their rights; and (c) the nature of the impact of the change on law upon those rights. 416 U.S. at 717, 94 S.Ct. at 2019.

In analyzing the exception, the Court of Appeals first incorrectly characterizes "the nature and identity of the parties." The record reflects that the management of LTV was anything but financially sophisticated. LTV was a small credit union for corporate employees. Its board members were present or past employees of the sponsoring corporation with no formal training or previous experience in banking, securities, investments or mortgage banking. LTV's manager, who entered the LTV

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negative pregnant, i.e., that if the retroactive application would extinguish the cause of action, the statute should not be applied retroactively, thus shifting the emphasis from the general rule and the "manifest injustice" exception to an objective standard — loss of cause of action — which has *never* controlled the issue.

[16] See argument and authorities at pages 8 to 11 *supra*.

Standby, had no formal training beyond high school, and other than his employment with LTV had no prior training or experience with investments or the investment activities of LTV. On the other hand, UMIC operated as an unlicensed, unregulated and unregistered dealer/broker engaged in multi-national unregulated trading of options in government securities. UMIC was not a member of any exchange or board of trade, making its "market" on the side. UMIC had over 100 "salesmen" who received "training" in UMIC's boiler room operation. It is patently obvious that UMIC's activities had been carefully developed by its principals and attorneys to take advantage of a perceived "loophole" in the statutory regulation of securities trading.[17] Thus, the Court of Appeals has relied on incorrect assumptions concerning the first element of the *Bradley* analysis by not truly understanding the nature and identities of the parties.

Likewise, the Court of Appeals is incorrect in its assumption that only "purely private" rights are involved in this case and that retroactive application would *unduly* prejudice rights of UMIC. First, that conclusion overlooks the very nature of UMIC's activities and assumes that the activities of UMIC were clearly lawful at the time of the LTV contract, despite the fact that it concluded that the issue of such commitments as securities

[17] Federally chartered corporate credit unions are not, in general, bastions of financial sophistication. Unlike the Court of Appeals, the drafters of the Report of the Joint Treasury — SEC — Federal Reserve Study of the Government-Related Securities Markets (App. D-1) recognized the relative unsophistication of small credit unions, especially in connection with GNMA "forward commitments." (Report, pp. 107-110, App. D-20 to 22). The Report also analyzes numerous of the abuses by unregulated sales operations just like UMIC, clearly falling within the very abuses alleged by LTV to have been committed by UMIC in this action. (Report, pp. 110-118, App. D-22 to 27). In recognition of the relative naivete of credit unions, the Congress and National Credit Union Administration have imposed severe restrictions on the suitability of the various investments for such credit unions. *Within weeks* after the LTV Standby was signed, the Administrator of the NCUA stated that such GNMA standby options were unlawful for credit unions. Shortly thereafter, the NCUA published proposed rules to this effect. See discussion at pp. 22 to 26, *infra*.

was uncertain under existing case law. 704 F.2d 203 (App. A-11). Thus the Court of Appeals bases its rationale on what it mistakenly decided was a contested and unresolved issue of statutory interpretation. A primary issue, which this Court has not yet passed upon directly is whether or not the federal securities laws prohibited UMIC's activities even prior to the 1982 Congressional Amendments. Irrespective of how *that* issue is decided, there can be no question that UMIC *had to know* that it was walking a *very* thin line and relying on a highly questionable private interpretation of the federal securities laws at the time it contracted with LTV.[18]

By June 1978, the various regulatory agencies had begun to recognize the threat posed by UMIC's interpretation of the exemption for government guaranteed securities.[19] UMIC is no innocent lamb which would be unfairly slaughtered by retroactive application. The *very purpose* of the federal securities laws has been to protect investors from traders like UMIC. No citation is necessary for the proposition that decisions of this Court for the past forty years have consistently recognized that one who interprets the federal securities laws narrowly in his favor to avoid compliance does so at his peril.[20] Given that judicial history, any party relying on an exculpative non-judicial

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[18] UMIC had clear reason to know by August 17, 1977, long before the LTV transaction herein, that it might well be in violation of federal law in such activities. *See, Letter of the General Counsel,* Commodities Futures Trading Commission, August 17, 1977, CCH Commodities Futures L.Rep. Paragraph 20, 467, (App. E-1), in which the GNMA Dealers Association (of which UMIC was a member) had sought the general counsel's opinion on legality of the type of trading involved herein. The general counsel first advised that these activities involved securities and commodities and were covered by federal laws on both, and then went on to point out that "the network of primary dealers that you describe in your letter may come within the Act's definition of a board of trade."

[19] See Report of the Joint Treasury — SEC — Federal Reserve Board of Study of the Government-Related Securities Market, (App. D-1 *et seq.*).

[20] As more fully set forth herein, there was no existing statutory or case law upon which UMIC could have found real comfort that its activities were exempt from the federal securities laws. To the contrary, UMIC's activities

interpretation of the definition of a "security" cannot have been totally unaware of the inherent risk in such interpretation. To bootstrap a decision on non-retroactivity on "surprise" or "manifest injustice" to UMIC is ludicrous in this factual and legal context.

Finally, LTV asserts that the underlying issue in this case *is* of "great national concern." Certainly the Congress, the NCUA, the SEC and the nation's financial markets were of that opinion. Since 1933, federal regulation of securities has been a major factor in national commerce. The very existence of a private right of action under the federal securities laws and Rule 10b-5 in particular, recognizes that the SEC cannot possibly, by itself, promptly identify and attack every financial scheme which violates the federal securities laws. Many of the historic developments in securities regulation have resulted from suits by a private party attacking a "private contractual obligation" that it entered.[21] Quite often, numerous of such landmark decisions and statutory changes resulted from what could have been characterized as "a common, routine cause of action — breach of contract" between private litigants, as the Court of Appeals characterizes this case. *See, Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917 (1975). Such benign characterization *does not lead* to the conclusion that the issue is not of "great national concern." Private parties have acted as "private attorneys general" for decades in shaping securities regulation on a national basis. The Court of Appeals has

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were, at the time of the LTV contract, under scrutiny by regulators attempting to determine if, as so many had been in the past, the pattern followed by UMIC was a scheme designed to capitalize on an arguably colorable but untested and invalid statutory interpretation of the federal securities laws. If courts refused to apply changes in existing statutes retroactively because one party *could* have relied on *its own* interpretation of existing statutes, the anomalous result would be to sanction widespread unlawful activities occurring while the parties sought definitive statutory interpretation for several years in the courts.

[21] See, e.g. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa., 1946), (the first private right of action was under 10b-5)

misconstrued the exception in *Thorpe* and *Bradley* for "manifest injustice." The "manifest injustice" in this case would result from *failure* to apply the statute retroactively. Allowing the opinion of the Court of Appeals to stand as rendered would legitimize the activities of entities like UMIC for the period to the effective date of the Congressional Amendments without any final judicial determination that such activity was in fact legitimate. It would mean every promoter could rely without peril on questionable interpretations of the federal securities laws and other statutes until this Court interpreted them or the legislature changed them despite existing administrative interpretations. If there ever was a statute that this Court should definitively state *must be* applied retroactively, it is this statute as to do otherwise would leave no remedy to those parties who were unlawfully sold these "securities" prior to the Congressional Amendments.

THE OPINION OF THE CIRCUIT COURT ERRONEOUSLY INTERPRETS THE DEFINITION OF AN "EXCHANGE"

The District Court's opinion (adopted by the Court of Appeals) is the first interpretation of the Securities Exchange Act definition of the term "exchange." 15 U.S.C. Sec. 78c(a)(1)[22] That opinion has completely emasculated the definition and straightforward criteria set forth therein. The elements of an "exchange" are: any organization which maintains or provides a marketplace or facility for bringing together purchasers and sellers of securities; or performs functions commonly performed by a stock exchange as that term is generally understood. UMIC employed approximately 100 salesmen in its offices located in five states; in addition to traders, clerical personnel, administrators and officers. The salesmen operated in the part of the facilities referred to as the "brokerage floor." In the Memphis office that was a large room which contained some 50

[22] App. F-29.

salesmen, all with desks and telephones and several traders. Blackboards were posted by the floor traders with current listings of securities either offered for sale or purchase. It was the salesman's job to move these securities by getting on the telephone and finding purchasers or sellers for these securities. The UMIC salesman who solicited LTV's participation in the transactions in question worked in the Houston office with 25 to 30 other UMIC salesmen. In describing these activities he stated that UMIC "made a market" by "bringing buyers and sellers together." According to UMIC's CEO none of these transactions were ever effected through a recognized exchange. UMIC performed all of the functions necessary for their business directly through the Memphis office or through agents. UMIC has never been registered as an exchange, nor has it ever been a member of any stock exchange or board of trade.

Under these facts it is clear that UMIC *was an exchange. In fact, it is admitted that they brought buyers and sellers* together for the purpose of making a market for securities.

It is not persuasive to contend that the application of this statute would make every securities dealer an "exchange" and therefore disrupt the market. The facts are that most recognized securities dealers are members of registered exchanges and conduct their business using such instrumentalities and *are subject to the rules of such exchanges.* They are therefore by the application of other laws not required to register as an exchange. That UMIC chose not to do so is not a defense. The LTV Standby was a contract made in violation of this section. As such it is void. 15 U.S.C. Section 78cc.

The District Court engrafted the agent — principal test into the statutory definition of "exchange."[23] The court has ignored

[23] The District Court stated: "The gist of LTV's argument is that UMIC is an "exchange" because it sometimes matches sales with purchases. That is, a customer of UMIC will inform UMIC that he is interested in purchasing certain securities. If UMIC does not have the securities on hand, it may seek out a seller from whom it can purchase the securities for resale. Conversely, when a potential seller offers to sell his securities, UMIC may first determine

its own admonition to look at the economic realities. By the simple fiction of making out two trade slips instead of one UMIC was permitted to dispense with compliance with the very statutes and regulations designed to protect just such "customers" as LTV. The record shows that UMIC had violated every exchange rule from "know your customer" to "minimum capital requirements." The District Court's opinion will create the framework by which all future cases under Section 78cc will be measured. It is not in keeping with holdings of this Court which employ a flexible approach, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek to profit at the expense of others by constantly avoiding what they perceive as the letter of the law in order to violate its spirit. *SEC v. Howey*, 328 U.S. 293, 84 S.Ct. 1100 (1963).

THE OPINION OF THE COURT OF APPEALS WILL CREATE UNCERTAINTY AS TO THE STATUTORY AND REGULATORY CONTROL OF INVESTMENTS BY FEDERAL CREDIT UNIONS

This is the first reported case to construe the statutory investment powers of federal credit unions, a matter of significance extending beyond the interest of the parties to this case. In adopting the District Court's opinion the Court of

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whether it has a purchaser before it buys the securities for resale. During a typical day or week, many such requests to buy or sell may be communicated to UMIC, which can then match offers to sell with offers to buy. This, LTV contends, constitutes the operation of an "exchange."

But the fact of the matter is that UMIC purchases and sells securities for its own account, albeit for eventual resale. As with any merchant of any commodity, it may choose not to make purchases until it has lined up customers, or make sales until it has found a source of supply. But that does not mean that UMIC is a marketplace or an exchange. Neither UMIC nor its salesmen — the "brokers" in LTV's scenario — are agents of those who purchase their securities from or sell their securities to UMIC; nor does UMIC owe its customers the fiduciary duties associated with an agent. UMIC buys securities as cheaply as it can, and sells them at the highest possible price, making its profit off the difference." 523 F. Supp. at 834 (App. B-42).

Appeals has created a rule of case law diametrically opposed to the apparent intent of Congress and the administrative agency charged with supervising federal credit unions.

Congress has for years recognized that federal credit unions are run by the members who are not sophisticated investors; its members would be people of "small means."[24]

Originally the *only* investments permitted to be made by federal credit unions were loans to members and investments in obligations of the United States or securities fully guaranteed thereby as to principal and interest thereon. In the 25 times Section 1757 of the Federal Credit Union Act (Powers), 12 U.S.C. Section 1757, has been amended since 1934 the investment authority of federal credit unions is still virtually limited to direct investment in U.S. government and agency securities.[25] Even these are specifically enumerated in 12 U.S.C. Section 1757(7). The investments permitted are "blue ribbon" and virtually risk-free as to payment of principal and interest. The enumeration of each specific type of investment by Congress implies the exclusion of *any others*.[26]

While LTV was permitted to invest directly in GNMA's, Standby commitments are not expressly enumerated.[27] No case found has implied that any non-enumerated investment may be included within terms of Subsection 1757(7).

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[24] Remarks of Sen. Sheppard, Congressional Record — Senate 1934, p. 7259, 7261.

[25] Statement of NCUA, 43 Fed. Reg. No. 201, page 47731. (App. F-63)

[26] See Texas & Pac. Ry. Co. v. Pottoff, 291 U.S. 245 at 253, 54 S.Ct. 416 at 417, (1934) ". . . the act under which national banks are organized constitutes a complete system for their government. . . . The measure of their powers is the statutory grant; and powers not conferred by Congress are denied."

[27] "(7) to invest its funds . . . in obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by, . . . the Government National Mortgage Association. . . ." 12 U.S.C. Section 1757(7) (App. F-11, 12).

The opinion of the District Court below premises its holding in deference to the prior interpretations of the NCUA. (523 F.Supp. at page 826, App. B-20 to 24). It then, however, fails to properly identify and utilize these official interpretations.

The NCUA had not expressed any clear and unequivocal opinion with respect to standby commitments at the time of the LTV Standby. However, its position was clearly spelled out to the annual convention of Federal Credit Unions in August 1978 by the Administrator of NCUA: "Standby contracts or other like commitments are in essence put options — futures — and thus separate securities from the underlying lawful securities and are unlawful for credit unions —." Shortly thereafter, in October 1978, proposed rules were published prohibiting just such Standby transactions.[28]

As pointed out by the NCUA such standby option contracts were not authorized by the statute even before they were specifically prohibited in October 1978.[29] In accompanying comments, the NCUA detailed numerous abuses of broker/dealers pointing out that credit unions relying on the expertise of such broker/dealers have suffered heavy losses resulting from speculation in a very volatile market and may present a potential loss to the National Credit Union Share Insurance Fund."[30]

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[28] "The Administration believes that in a standby commitment one party purchases an option to sell and deliver the securities at a future date. The other party creates the option by agreeing to 'standby' to purchase the securities if the first party elects to sell. *Thus, the investment powers of Federal credit unions (see, 12 U.S.C. 1757(7)) do not include the authority to purchase or sell such an option.* This conclusion is specifically set forth at 12 C.F.R. 703.3(b)(2), which provides that Federal credit unions may not enter into standby commitments to purchase or sell securities." (emphasis added) Federal Register, Vol. 43, No. 201 — Tuesday, October 17, 1978, pp. 47731-32. (App. F-63, 64).

[29] "A Federal credit union may not enter into a standby commitment to purchase or sell a security." 12 CFR 703.3(a)(2).

[30] 43 Fed. Reg. 201 at pages 47731-32. (App. F-63, 64).

The NCUA obviously did not consider these regulations a new addition to existing law, but rather a concise statement of the meaning of the statute and a clear prohibition against investment in standby commitments. The Court of Appeals merely adopted the District Court's opinion holding that LTV had the statutory authority to enter into the LTV Standby. The opinions below state that the NCUA's new rule was expressly not retroactive. That position results from a misapprehension of the NCUA's statement.[31] The very first time that the NCUA proposed a regulation on this question, it clearly stated *"the investment powers of federal credit unions (see 12 U.S.C. 1757(7)), do not include the authority to purchase or sell such an option."* This regulation was the first official administrative pronouncement on the subject. The same inappropriate application was rejected by this Court in *Manhattan General Equipment Co. v. Commissioner of Internal Revenue*, 297 U.S. 129, 56 S.Ct. 397 (1936).[32] The holding in this case has already produced disastrous

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[31] The District Court fails to distinguish between the enumerated transactions that were declared to be "not authorized under this Act or constitute unsafe and unusual practices as explained below." 43 Fed. Reg. 201, p. 47731. (App. F-63). It is clear that the NCUA did not intend to legalize "unauthorized" transactions but simply stated that as to the "unsafe and unsound" transactions that the NCUA would not apply any retroactive administrative sanctions, if the credit unions "begin to wind down those activities in a safe and orderly manner." 44 Fed. Reg. 141, page 42676.

[32] "The power of an administrative officer or board to adminster a federal statute and to prescribe rules and regulations to that end is not the power to make law, for no such power can be delegated by Congress, but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. [citations omitted]

"The contention that the new regulation is retroactive is without merit. Since the original regulation could not be applied, the amended regulation in effect became the primary and controlling rule in respect of the situation presented. It pointed the way, for the first time, for correctly applying the antecedent statute to a situation which arose under the statute." 297 U.S. at 134, 56 S. Ct. at 400.

results not only has it cost the members of the LTV Federal Credit Union over $1,700,000, but it will be cited against other federal credit unions whose cases are just now winding their way up through the courts. In addition, it virtually destroys any hope that some of the losses incurred by the abuses and pure speculations as discovered by the NCUA can be recovered under the "faithful performance bonds" used by federal credit unions to cover the actions of their managers (the only paid officer or director).

Further it allows the unscrupulous brokers and dealers to escape with their ill gotten profits.[33] Even though the statute was there to provide the protection, the courts below refused to enforce it.

Petitioners would urge that the issue of retroactive application of the NCUA regulation, 12 C.F.R. 703.3(a)(2) was improperly decided as the Court of Appeals ignored the general presumption of retroactive application of regulatory changes.[34]

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[33] This was clearly recognized by the NCUA:

"This Administration believes that some brokers and dealers are not using forwards as they were originally intended, but rather as a means of increasing their own profits and commissions at the expense of their customers . . .

"Additionally, it appears that brokerage firms which deal in government securities have taken little or no action to police their members . . .

"The Administration cannot foresee when and if the abuses in the forwards market will be corrected. *Therefore, the Administration proposes to prohibit Federal credit unions from engaging in the two types of forwards because the transactions are either not authorized under the Act or constitute unsafe and unsound practices as explained below.*" (emphasis added) Federal Register, Vol. 43, No. 201 — Tuesday, October 17, 1978. (App. F-64).

[34] See argument and authorities, pages 15 to 20, *supra*.

CONCLUSION

The opinions of the courts below involve the initial construction of two significant federal statutes and determines the application of new amendments to the definition of a "security." In addition the opinions of the courts below cast serious doubt on the significance of this Court's recent action in the disposition of the *Board of Trade* case, a matter which involves substantial national interest.

The Court of Appeals has erroneously decided important questions of federal law which should be reviewed and settled by this Court.

Petitioner respectfully requests that a writ of certiorari issue to review the judgment of the Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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